Private Bank

CIO Strategy Bulletin

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“V” is for Victory: Investor Doubts at a Time of Maximum Covid

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When a country is at war, it is hard to imagine peacetime. The news of new Covid variants, insufficient vaccine supplies and peaking Winter infection and death rates are hard to square with a stock market reaching new daily highs in the US and China. Given investor experience with the market recovery from the 2008 Financial Crisis, many rightly wonder if the US and world economy can really snap back quickly from the Covid recession of 2020.

Let’s look at the data. Vaccinations are just beginning (see Figure 1). The US exceeded the rate of 1 million doses a day just last week. To date, 5% of the US population has received at least one shot of the vaccine. Meanwhile, January 2021 looks to become the deadliest month of the pandemic with nearly 100,000 deaths likely. However, the seasonality of the disease shows that there are improving trends even before the vaccine becomes widely available. New cases, hospitalizations and deaths are, thankfully, already trending lower and the nature of the coronavirus suggests the deceleration may gain speed. This would create ideal timing for vaccinations, as the best time to give them is when the disease is in abeyance. Thus, a “third wave “of Covid may be mitigated and herd immunity achieved sooner. Dr. Anthony Fauci suggested on January 22 that immunity may be reached by September in the US.

The economy faced great turmoil from the pandemic. The most Covid-impacted sectors of Transportation, Recreation, Food Services and Accommodations declined by the equivalent of 25 years of growth in the Spring of 2020. Some of that decline shifted consumption towards goods, as consumers purchased appliances, fitness equipment and electronics in record volume. This drove shortages throughout the year and a revival of imports from Asia, boosting that region.

The health threat is now again holding down economic activity more noticeably (see Figure 2). In December, the US posted the first monthly decline in employment in nine months on renewed weakness in leisure and hospitality. And there is the possibility that new variants of Covid might extend the “season” for the virus later into the spring.

Thus far, financial markets have been able to look past these dark days and conflicting narratives. The election of President Biden who has proposed massive new stimulus as well as program of mass vaccination, has countered the devastating health news and worsening labor market.

This past week, assets most geared to economic recovery have begun to consolidate gains as we warned might happen in last week’s bulletin (please see CIO Bulletin Jan 17 and Figure 3). Investors will mostly “look ahead” during the current 4Q 2020 EPS reporting season, but there is plenty of evident weakness for the most impacted firms.

Some investors must be harboring doubts after a strong market rally, with the consensus of US economists having marked up their 2021 GDP forecasts to a 4.3% gain. Plenty are competing to show off the most attention-getting high forecast. Broadly speaking, it is critical that the economy begin to deliver on its ample recovery promises sooner than later.

Figure 1: COVID-vaccinated share of population by country

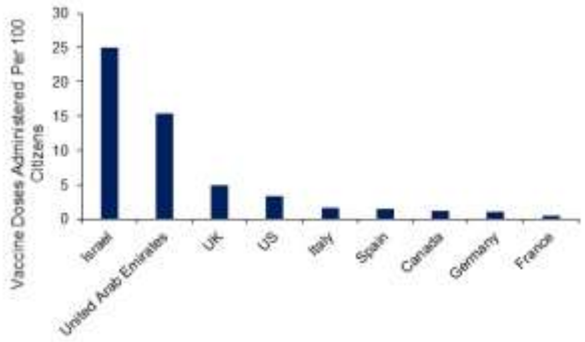
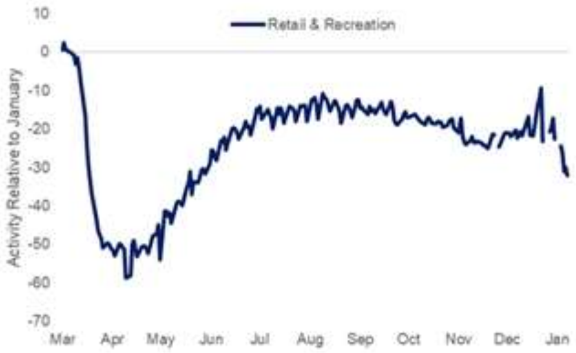
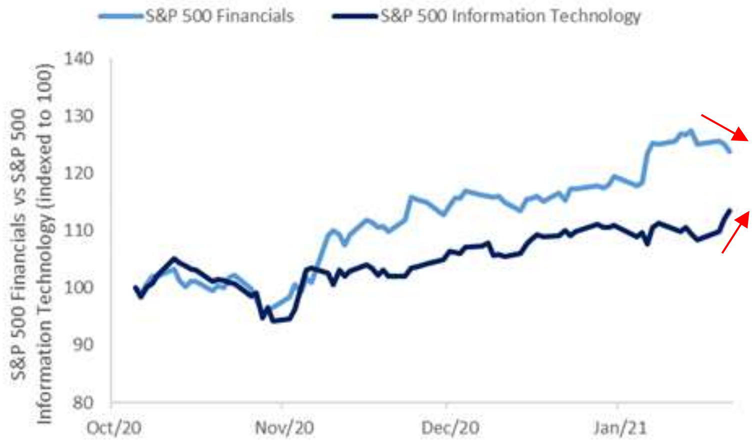


Figure 2: Global Mobility: Retail and Recreation



Source: Haver as of January 21, 2021. Note: Data in Figure 2 are provided globally by Google Inc. for the movement of people close to retail and recreation sites.

Figure 3: US Information Technology and Financial Sectors



Source: Haver as of January 22, 2021. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Why the "V" Is Still Likely for Economy

In 2021, the economy faces a very different set of challenges than it did in 2008. We do not expect a "Hockey Stick" shaped recovery now, where the slow pace of improvement kept the Fed on the sidelines for nearly 7 years. We believe that a more aggressive "V-shaped" recovery is likely. There are many elements for this view. First, the economy did not have major vulnerabilities when the pandemic began. Second, governments provided rapid and ample fiscal stimulus while the central banks ensured markets remained highly liquid. Third, technology enabled large parts of the economy to function despite social distance. Fourth, as services spending fell, good purchases boomed. This was enabled by the rapid, emergency stimulus too.

Government income support softened the pandemic's blow. Despite historically rapid job losses which suppressed wages, aggregate US consumer income in the first 11 months of 2020 was up nearly 4% over the prior year. This was a very healthy increase even before the most recent round of stimulus checks authorized in December (see Figure 4).

Now, as we contemplate the end of the pandemic, we see factors that indicate a rapid acceleration of the economy may be at hand. More fiscal stimulus, the reopening of the most impacted services sectors, the refilling of the supply chain for commodities, unfinished and finished goods, and the expected burst of "economic relief" when people leave home for good portends a sharp recovery. **Exactly when the economic lights get turned back on is almost entirely**

dependent on the speed and success of the current Covid vaccination effort. Almost all of the current economic weakness is heavily concentrated in “Socially Close Activities” that have been shut down to prevent the spread of the virus (see Figure 5). These are the sectors that will benefit most from the broadening out of the post-pandemic recovery.

Figure 4: Covid Drove Substitution of Goods for Services and Stimulus Substituted Government Payments for Wages

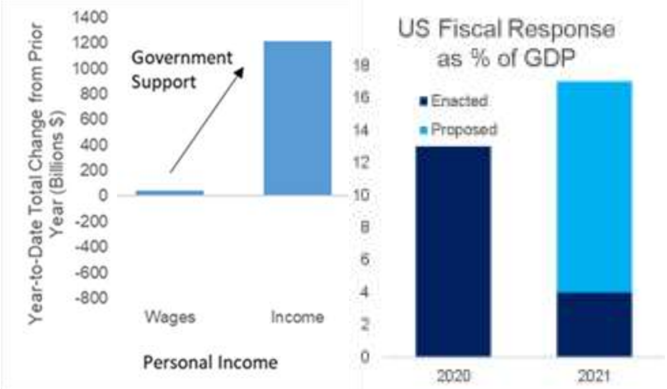
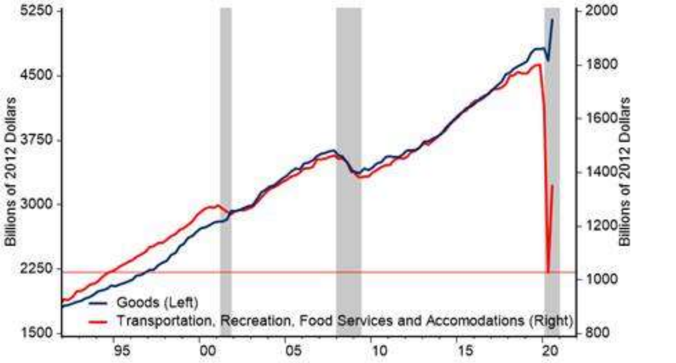


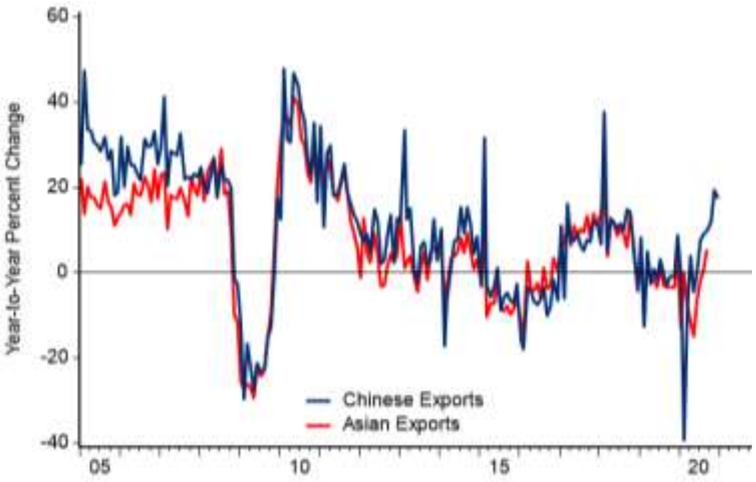
Figure 5: Real Goods Consumption and Select Socially Close Sectors



Note: Shaded areas are recession. Source: Haver as of January 21, 2021.

The sharp rise in goods consumption during the pandemic came at the expense of services. This means there will be a rotation away from goods spending, perhaps as early as 2H 2021. The many home electronics, computers and media purchases of the “shut in” period “pulled forward” demand. Thus, there will be no need to repeat some of the purchases in 2022, for example, a recently bought television. Given this dynamic, we do not view a rebound in services spending as 100% additive to the future growth pace. Goods producers in Asia will likely see their very strongest export growth rates early in this recovery phase (see Figure 6).

Figure 6: Chinese and Broader Asian Exports to the World



Source: Haver as of January 22, 2021.

Yet the US savings rate is one reason why our confidence is a sharp rebound in overall growth is high. In addition to stimulus checks, much of the savings from the collapse in services spending **has not yet been spent.** The US savings rate temporarily reached the highest level on record in April 2020 (see Figure 7). Even in late 2020, the latest period without additional stimulus checks, household savings in the aggregate are far above recent norms. A full recovery in social close services to the level that prevailed before Covid would require a $400 billion rise in spending from the 3Q level, equal in magnitude to the last 15 years of growth for these sectors. And yet that is possible.

The net worth of households has increased rapidly throughout this recession and that is atypical (see Figure 8). We do not normally think in terms of pent up demand for services like vacations and restaurant meals as people don’t typically take two vacations in a single year if they missed one the prior year. That said, with money in their pockets after 14 months of confinement suggests that people will indulge. We can even imagine a shortage of airline seats this summer and fall.

The story of inequality only got worse with the pandemic and its outsized impact on lower-wage paying industries. While employment is still roughly 10-million below the prior peak, and countless more households are suffering from income loss as well as human loss, bank balances and historically low mortgage rates suggest that the majority of the public can and will spend some of their savings and have room left due to lower housing and fuel costs.

Figure 7: Consumer Savings Rate

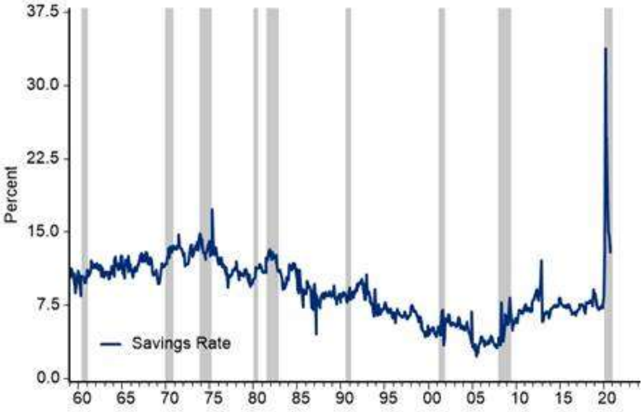
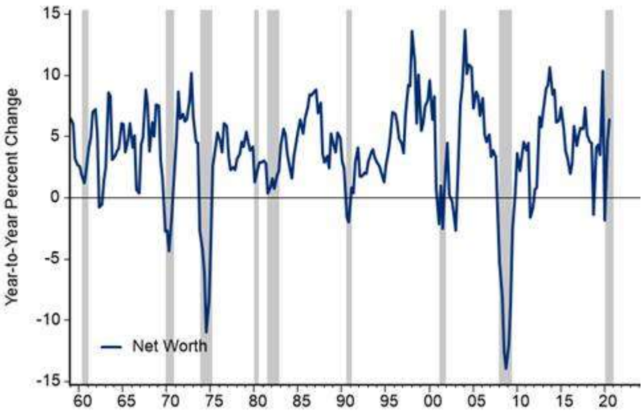


Figure 8: Household and Non-Profit Real Net Worth



Note: Shaded areas are recession. Source: Haver as of January 21, 2021.

Of course, the GDP story does not end with the consumer. GDP incorporates *investment, government spending and net exports*. And while consumption makes up nearly 70% of GDP and will drive the largest and most durable portion of the recovery, the other elements are geared towards a solid growth revival as well.

The shift from services towards goods consumption has led to shortages of many consumer goods. This drove a major destocking last year, such that the level of retail inventories to sales has collapsed (see Figure 9). As the recovery sets in further and activity returns to normal, firms will have the clarity rapidly rebuilding inventories and accelerated capital spending on improvements (see Figure 10). In addition, US exports have fallen much more than US imports, as the US is a net exporter of services which have been profoundly impacted by Covid.

Figure 8: US Inventory to Sales Ratio

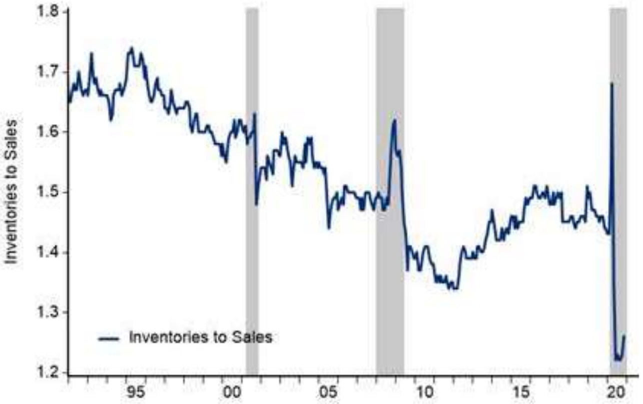
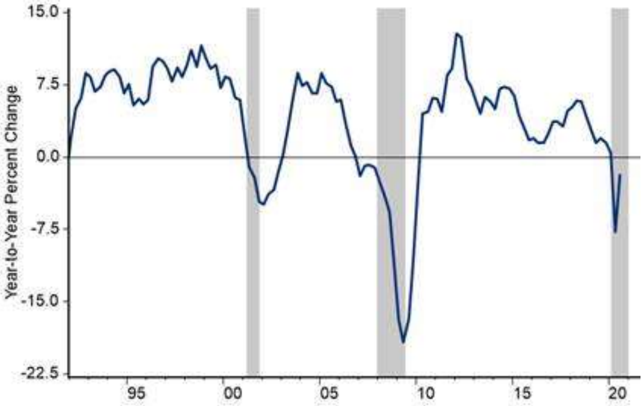


Figure 9: US Real Private Fixed Investment

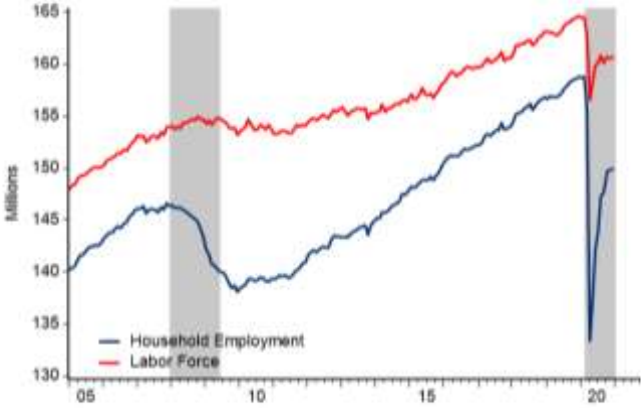


Note: Shaded areas are recession. Source: Haver as of January 21, 2021.

And then there is government spending. The tone in Washington has shifted dramatically with the swearing in of President Biden this week. With united Democratic control of both chambers of Congress as well as the White House, it is increasingly likely we will see some form of major investment in “green infrastructure.” The economic situation is ideal for such a push, with millions out of work (see Figure 11) and borrowing rates at historical lows able to supply both labor and capital towards the Biden’s stated goals of fighting both the economic impact of Covid and the environmental crisis of climate change.

A super-majority would be necessary in congress to push through a major new entitlement or any other item that would impact the deficit outside of the current decade. However, the so-called reconciliation process will likely allow the Democratic majorities to pass a large dollar value green infrastructure and recovery plan with minimal bi-partisan support.

Figure 11: Household Employment and Labor Force



Note: Shaded areas are recession. Source: Haver as of January 21, 2021.

In Europe the Same

Although the ongoing global economic recovery is very likely to be uneven, signs of this pent up economic demand can also be abroad with the European Union's households' gross savings rate surging from 11.5% pre-pandemic to 23.9% in the second quarter of 2020 (see Figure 12). While Europe is also struggling to contain the virus, with mutations allowing for more rapid spread, successful vaccinations over the next year are likely to result in a favorable decline in their households' savings rate as consumers begin to enjoy social interaction once again (see Figure 13).

Figure 12: EU Households' Gross Savings Rate (%)

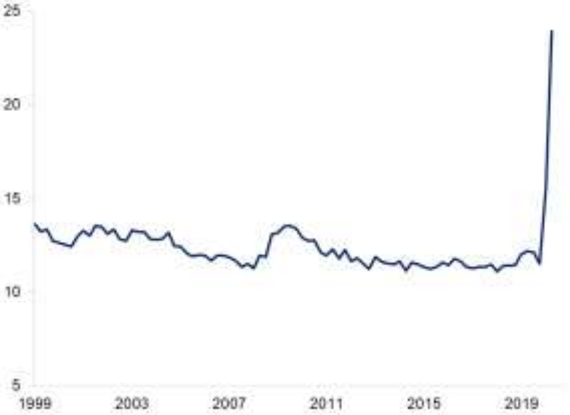
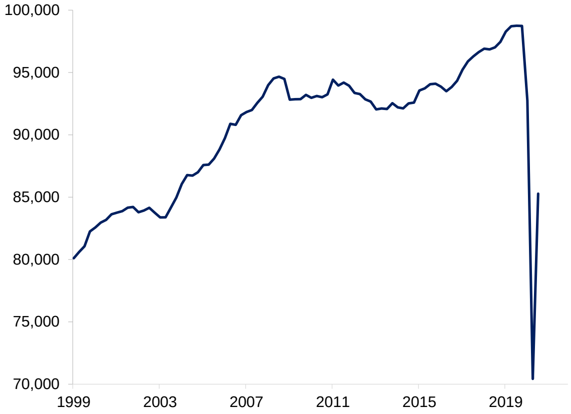


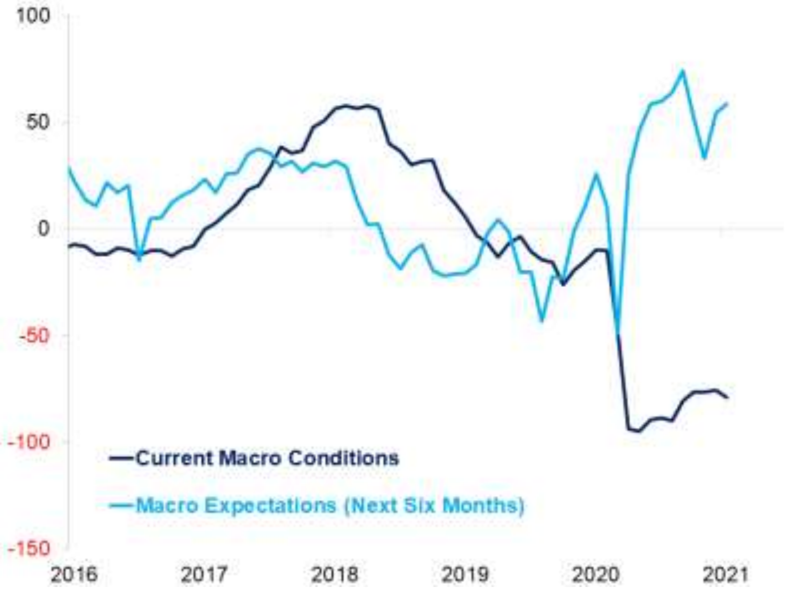
Figure 13: EU Gross Value Added in Arts, Entertainment, and Recreation



Source: Haver Analytics as of 2Q 2020.

Economic growth may remain challenged over the next 1-2 quarters as we struggle through renewed (though less severe) social restrictions. As noted, financial markets are largely looking past this with macroeconomic expectations looking six months out materially better than current conditions reflect (see Figure 14). While this wide divide between current conditions and expectations poses a risk of disappointment, the trends discussed above leave us hopeful and optimistic that those conditions will be met.

Figure 14: EU's Economic Sentiment (% Balance)



Source: Haver Analytics as of January 22, 2021. Note: The ZEW Financial Market Survey (Finanzmarkttest) is a monthly survey among 350 financial analysts and institutional investors in Germany. It has been conducted since 1991. Participants are asked about current conditions and their six-month expectations concerning the economy, inflation rates, interest rates, stock markets and exchange rates in the Euro area, Germany, Japan, United States, United Kingdom, France and Italy as well as their expectations concerning oil prices. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only. Past performance is no guarantee of future returns. Real results may vary.

Follow the V (Don't Get Caught in an Off-Ramp)

As we said earlier this month (please see CIO Bulletin | Fear and Irrational Exuberance, or Reconstruction and Growth?), last year's 19% gain in US and global equities in the face of the 2020's collapse now requires a sharp profit recovery and low interest rate polices to endure. Both are likely (see Figures 15-16). A wide variety of early-cycle indicators from trade and manufacturing suggests the 20% US EPS gain we have long expected for 2021 is readily achievable or can be exceeded. Most importantly, this would mark only the beginning of a new expansion phase. The economy will not be near a peak again any time soon. Easy macro policies are more likely to outlast the pandemic's direct impact, making the 26% gain in global EPS expected by analysts this year achievable, with more gains beyond. Central banks will not waiver in their commitment to see the recovery fully through.

We have long strived to have realistic views of the crisis impact which temporarily resulted in the fastest US and global GDP declines in history during 1H 2020. (Recall our early forecasts for -40% and +30% US GDP swings in 2Q/3Q?) Our estimates still anticipate hospitality and travel industries remaining depressed in 1H 2021, and commercial construction to lag recovery. This is as the office sector takes longer than usual to recovery as businesses learn to adapt to telecommuting. As such, we have long assumed US GDP growth in 2021 - with its depressed1Q Covid-winter quarter included - would hold the full year just below 4%. Yet passage of a larger fiscal stimulus package, closer to the Biden plan discussed last week, would likely boost US growth measurably above that level. This is even if none of the other negatives we mentioned are erased.

Of course, a volatile, policy- and pandemic-swayed path for the US and world economy can mean turmoil below the surface for markets. Last week, we noted that South Asian equity markets lagged far behind the North in pricing recovery; Latin America far behind the US. Markets face other important factors: Despite some rise in US long-term interest rates to date, a broader and stronger post-pandemic economy would most likely result in further upward pressure. When this happens, monetary policymakers in our view are unlikely to "double down" on stimulus. This is not the environment in which growth stock valuations repeat their rise of 2020. These are among many factors driving our evolving investment selection.

Bears have been “capitulating” to the logical view that vaccines are a game changer for the world economy. This has driven a rapid stage of market gains (see Figure 17). It is historically clear that markets don’t maintain consistent upward momentum even when full-year gains are strong. We can think of no recovery/expansion year without some market setbacks.

What we ask investors is to expect markets to reflect the economy’s path, and see monetary policy as part of that outlook. Financial markets lead the economy, but if the world economy is merely at the “low point of the V,” it would be wrong to think markets have already discounted more than a full recovery.

Here, finally, we would point to similarities to 2008/2009. After 2009’s 35% gain, world equity markets went on to post positive returns in 9 of the next 11 years. Growth is normal, following the pandemic’s end, it will be great to get used to that again.

Figure 15: World Equities vs EPS 6-Months Ahead: Analyst Estimates for 2021

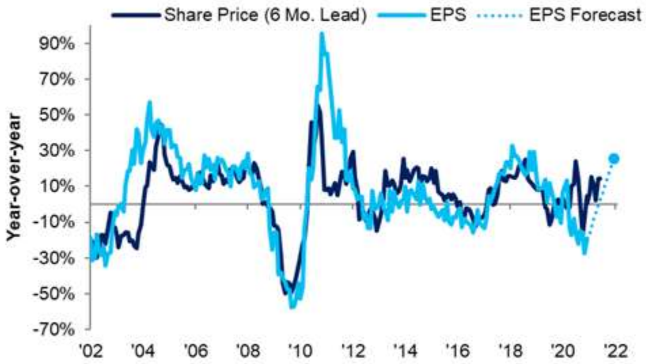


Figure 16: US Fed Funds Rate and Fed Projections Through 2023

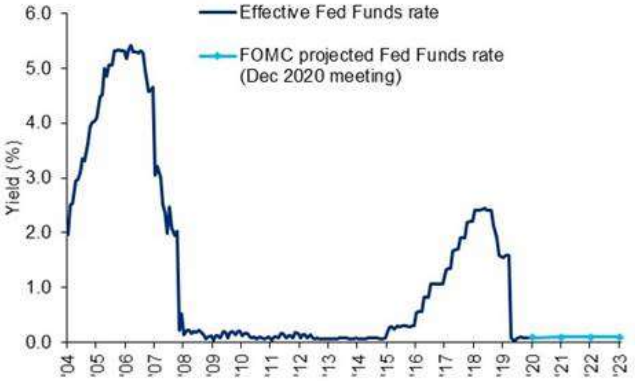


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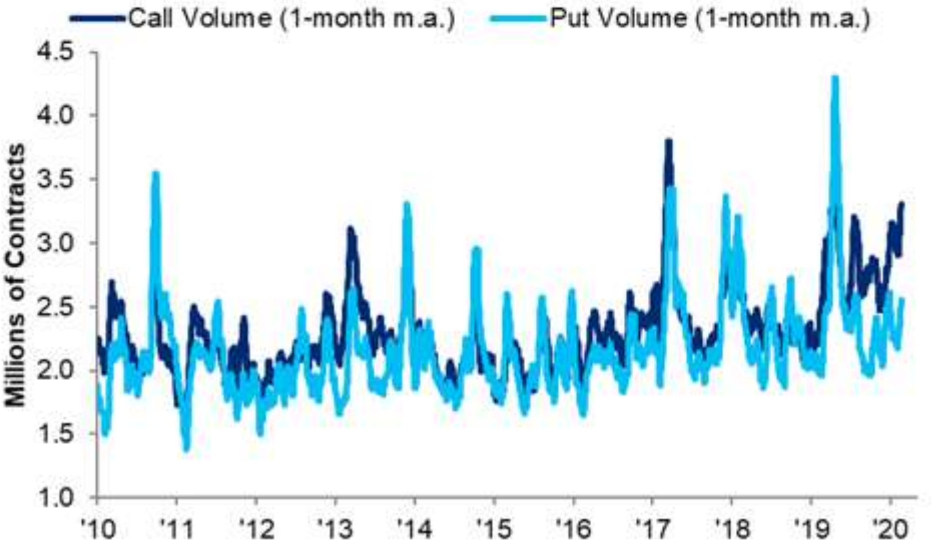
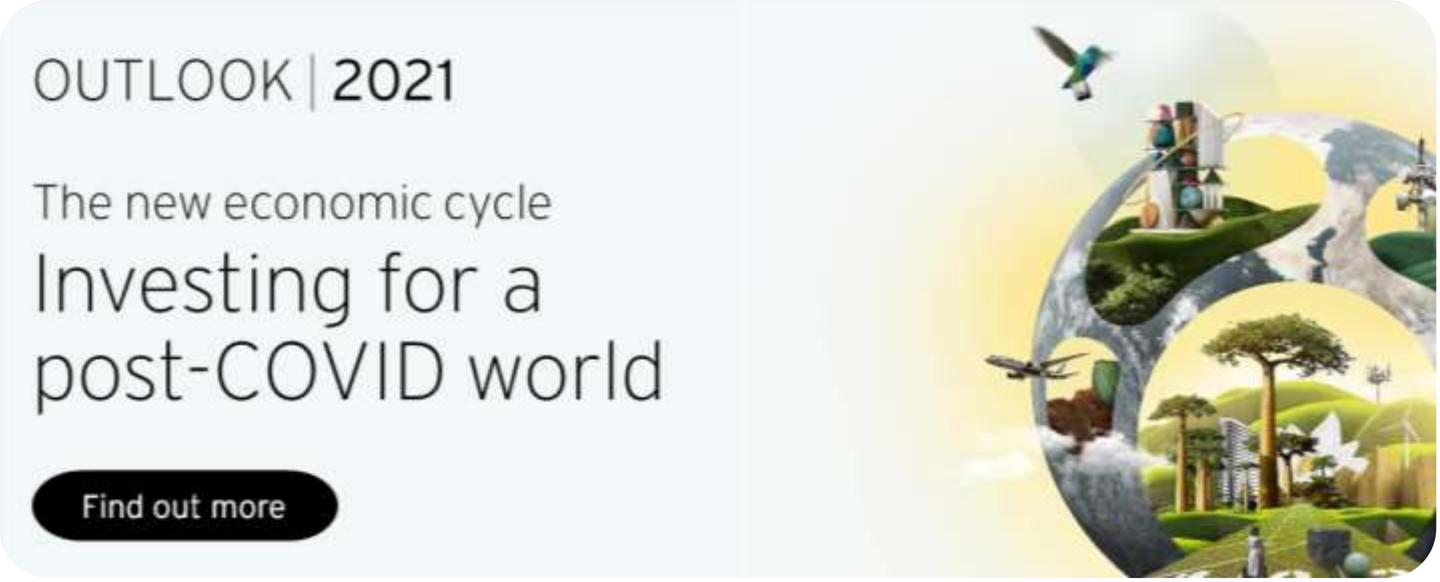
Figure 17: Equity Call Buying “Running Hot” Relative to Puts



Source: Haver Analytics as of January 22, 2021. Options in general are not suitable nor appropriate for every investor and involve risks. This is shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.



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